Court of Appeals for the Second Circuit held that the legal expenses incurred in that recovery were fully deductible even though the funds recovered were held to be a return of capital. In so holding, the Court of Appeals stated, at page 826:

> "It must be remembered that this taxpayer had a banking house in Germany where balances were kept. The cost of the recovery of these balances through the Mixed Claims Commission comes directly within the specifications of deductions for expenses. The proceedings before the Mixed Claims Commission were for the purpose of recovering assets for the taxpayer." To the same effect, *Commissioner* v. *Ullmann, supra.*

In *Alexander Sprunt & Son, Inc.* v. *Commissioner, supra,* the Court of Appeals for the Fourth Circuit held that legal fees incurred in the recovery of insurance premiums were deductible.

In *Missouri-Kansas Pipeline Co.* v. *Commissioner,* (issue 2), *supra,* the petitioner had paid attorney's fees awarded for services while petitioner was in receivership. It later developed that the attorney had an adverse interest. The legal fees and expenses incurred by the petitioner in the litigation to recover those attorney's fees were held to be deductible.

In *Ticket Office Equipment Company* v. *Commissioner, supra,* the Tax Court held that legal fees and expenses incurred to effect settlement of a fire loss were deductible.

To the extent that the decision of the Tax Court in *Pennroad Corp.* v. *Commissioner,* 21 T.C. 1087 (1954), affirmed on another issue in 228 F. 2d 329 (3rd Cir. 1955), relied on by the Tax Court and the Court below

in the instant case, concludes that legal expenses incurred in the recovery of capital are not deductible as business expenses, the petitioner submits that the decision is erroneous. So far as the petitioner is aware, the only commentator on the *Pennroad* case also believes it to have been wrongly decided [See, Brookes, "Litigation Expenses and the Income Tax" (March, 1957), 12 Tax Law Review 253].

As Judge Davis of the United States Court of Claims recently stated, regarding the deductibility of business expenses related to capital transactions:

> "In the tax law, 'capital' is a word of many meanings and varying consequences, depending on the context and connotations. The rule that legal expenditures are non-deductible when made in connection with certain 'capital' transactions does not mean that, by a Pavlovian reflex, they must always be non-deductible when 'capital' is involved, though the transaction and occasion differ radically." *California and Hawaiian Sugar Refining Corp., Ltd.* v. *United States,* 311 F. 2d 235 (C.Cls. December 5, 1962), at page 243.

2. The decision below is erroneous and contrary to the principles laid down by this Court in *Trust of Bingham* v. *Commissioner,* 325 U.S. 365 (1945).

The Court below and the Tax Court, in holding that legal expenses incurred in the recovery of income are deductible, but that legal expenses incurred in the recovery of capital in the form of property or money are not deductible, misapplied to this case concepts applicable only to the deduction of *non-business* expenses under Section 212(1) and (2) of the 1954 Code and its predecessor, Section 23(a)(2) of the 1939 Code.

In the *Bingham* case, this Court, in holding the legal expenses to be deductible under Section 23(a)(2), stated at page 373:

> "Section 23(a)(2) is comparable and *in pari materia* with §23(a)(1), authorizing the deduction of business or trade expenses. *Such expenses* [i.e., business expenses] *need not relate directly to the production of income for the business.* It is enough that the expense, if 'ordinary and necessary', is directly connected with or proximately results from the conduct of the business. * * *. The effect of §23(a)(2) was to provide for a class of non-business deductions coextensive with the business deductions allowed by § 23(a)(1), *except for the fact that, since they were not incurred in connection with a business, the section made it necessary that they be incurred for the production of income or in the management or conservation of property held for the production of income.*' * * *." [Italics added]

The Court of Appeals for the Second Circuit recognized the distinction between the deductibility of business expenses and non-business expenses, clearly drawn by this Court in the *Bingham* case. In *Commissioner* v. *Macy*, 215 F. 2d 875 (2d Cir. 1954), the Court rejected the Commissioner's argument, stating, at page 877:

> "* * * Bingham's Trust was a case involving a deduction claimed under 23(a)(2): it does not hold that a payment not necessary and ordinary to the objective stated in 23(a)(2) cannot be necessary and ordinary to the *broader objective of Sec. 23 (a)(1).* Rather, we read Bingham's Trust as holding that under both paragraphs of the Section the payments to be deductible must have been 'directly connected with or proximately result from the enterprise,' and that under Section 23 (a)(2) the payment must further be an expense incurred for the production of income or in the management of income-producing property." [Italics added]

3. The issue raised by this case presents an important problem in the interpretation and application of the internal revenue laws which should be settled by this Court.

The problem is whether legal expenses incurred in the recovery of money capital are deductible. It is submitted that such expenses are properly deductible because there is a fundamental difference in the consequences of capitalizing the cost of recovering money and of capitalizing the cost of recovering other property.[1] If property other than money is recovered and a current deduction for the cost of litigation is denied, that cost can be added to the basis of the property and will be recoverable through depreciation or when the property is sold. But if a judgment for money is obtained and the legal expenses are capitalized, they are neither recoverable through depreciation nor upon sal Money is not the kind of property to which expenses can be ascribed for tax purposes, because money never has a "basis" other than its face amount.[2]

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

CHARLES T. AKRE
1001 Connecticut Avenue
Washington, D. C. 20036
Attorney for Petitioner

September, 1964

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[1] See, Brookes, "Litigation Expenses and the Income Tax", 12 Tax Law Review 253 (March, 1957).

[2] Except in the case of numismatists or others dealing in currency as property.

APPENDIX

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 17,377

IOWA SOUTHERN UTILITIES COMPANY, a Corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Petition for Review of the Decision of the Tax Court of the United States.

[June 25, 1964.]

Before VOGEL, BLACKMUN and RIDGE, Circuit Judges.

BLACKMUN, Circuit Judge.

The Tax Court has decided that there is a deficiency of $74,330.15 in Iowa Southern Utilities Company's 1955 federal income tax. Judge Mulroney's opinion, not reviewed by the full court, is T. C. Memo. 1962-267. The taxpayer has petitioned for review.

The sole issue before us is whether certain attorneys' fees and expenses incurred in a successful shareholders' derivative suit and directed to be charged to the taxpayer are deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any

trade or business" under § 162(a) of the Internal Revenue Code of 1954, 26 U.S.C.A. § 162(a).

The facts are stipulated. The taxpayer is a public utility manufacturing and transmitting electrical energy. It has its principal place of business at Centerville, Iowa. It files its income tax returns on the accrual-calendar year basis.

In 1943 minority shareholders of the taxpayer instituted a derivative action in an Iowa state court against George M. Bechtel (the taxpayer's majority shareholder and its former president and director) and others. The complaint in that suit alleged, among other things, that Bechtel, his son Harold, and other named persons secretly acquired properties at prices far less than those at which they turned them in to the taxpayer, and had wrongfully appropriated these illegal excesses. The litigation, although not successful for the plaintiffs in the trial court, was brought to a conclusion in January 1952 when the Supreme Court of Iowa ordered, inter alia, that judgment based on the property manipulations be entered in favor of the taxpayer corporation and against the Bechtels and the Estate of J. Ross Lee in an amount exceeding $2,200,000. The court's lengthy and informative opinion is *Des Moines Bank & Trust Co.* v. *George M. Bechtel & Co.*, 243 Iowa 1007, 51 N.W.2d 174 (1952).

Thereafter, in 1953 and 1954, the taxpayer collected over $487,000 for application on the Bechtel-Lee judgment. It did not report these collections as income.

The attorneys for the plaintiffs in the derivative suit then applied to the Iowa court for an allowance of fees and expenses. In June 1955 the court entered judgment in favor of the attorneys and against the taxpayer in an amount in excess of $160,000. This was paid by the taxpayer in 1955. In its income tax return for that year the taxpayer deducted the amount so paid as an ordinary and necessary business expense. Its disallowance, to the ex-

tent attributable to the Bechtel-Lee judgment, has resulted in the deficiency now in issue. (The portion thereof allocable to salary and interest items has been allowed and is not in issue here).

Judge Mulroney's approach was that the expenditure, in order to be deductible under § 162(a), must qualify as an expense; that money spent in acquiring or recovering capital is not an expense; that the recovery due to the property manipulations was one of capital; and that legal expenses in connection with such a recovery of capital are not deductible.

The taxpayer argues that it is oversimplification and ignoring reality to say, as the Tax Court did, that a recovery is either of income or of capital and that if it is of capital the expenses incurred with respect to it are not deductible; that legal fees and expenses incurred in the recovery of business assets are deductible as a business expense under § 162(a); that any limitations imposed upon the deductibility of non-business expenses for individuals, under § 212, do not apply in determining deductibility of business expenses under § 162(a); that the Tax Court's rule that if a recovery is of capital the expenses are not deductibile has application only to a deduction asserted under § 212; that the legal expenses paid here were not incurred in the acquisition or improvement of any property or in the perfection of title thereto; that the courts have uniformly held that fees and costs incurred in a shareholders' derivative action and assessed against the taxpayer corporation are deductible as ordinary and necessary expenses of the business; and that, because cash rather than tangible property is involved here, the expenses cannot be added to the cost of cash and, if not now deductible, are permanently lost for tax deduction purposes.

This court has had more than one occasion recently to rule upon the question whether a payment qualified as an

ordinary and necessary expense deductible under either § 162(a) or § 212, or as a capital expenditure not deductible under §263(a), all of the 1954 Code, or under the corresponding sections of the 1939 Code. We have noted what we regarded as established rules, namely, (a) that, to be deductible, an item must be ordinary, necessary, and an expense; (b) that § 162(a) and § 263 are not mutually exclusive or all-inclusive; (c) that it is long settled that expenses of litigation made "to defend or perfect title to property" are capital expenditures constituting a part of the cost of the property and are not deductible (see, for example, *Addison* v. *Commissioner*, 177 F.2d 521, 523 (8 Cir. 1949); *Lewis* v. *Commissioner*, 253 F.2d 821, 827 (2 Cir. 1958)); (d) that, however, the mere fact that title to property happens to be involved in litigation does not necessarily mean that the litigation expenses are not deductible; and (e) that, under *Welch* v. *Helvering*, 290 U.S. 111, 114 (1933), there is no "ready touchstone" for these cases, that the statutory standard "is not a rule of law; it is rather a way of life", and that "Life in all its fullness must supply the answer to the riddle" or, in other words, each case bears its own investigation and analysis and is to be decided accordingly. *In re Buder's Estate*, 330 F.2d 441, 443 (8 Cir. 1964); *General Bancshares Corp.* v. *Commissioner*, 326 F.2d 712, 714, 716 (8 Cir. 1964); *Industrial Aggregate Co.* v. *United States*, 284 F.2d 639, 644-45 (8 Cir. 1960); see *Gravois Planing Mill Co.* v. *Commissioner*, 299 F.2d 199 (8 Cir. 1962).

We observe, further:

1. There is no question here that the subject matter of that part of the derivative suit which resulted in the Bechtel-Lee judgment was capital in nature, viz., the excessive portion of the purchase price of assets transferred to the taxpayer. The taxpayer does not contest this or that the collections effected and applied to the judgment were a return of capital. In fact, it treated the non-interest and non-salary portion of the recovery as capital, for it

was not included as income in its returns. The assets in question were identified and are listed and described in the Iowa opinion, p. 1078 of 243 Iowa and p. 214 of 51 N.W.2d.

2. A deduction is dependent "upon the legislative policy expressed in the fair and natural meaning" of the statute. *Lykes* v. *United States*, 343 U.S. 118, 120 (1952). The Court has also stated that a taxpayer has the burden of clearly showing its right to a claimed deduction. *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943).

3. Whether an expense is ordinary and necessary and whether it is related to business "are doubtless pure questions of fact in most instances". *Commissioner* v. *Heininger*, 320 U.S. 467, 475 (1943); *Long* v. *Commissioner*, 277 F.2d 239, 240-41 (8 Cir. 1960); *General Bancshares Corp.* v. *Commissioner*, supra, p. 717 of 326 F.2d; see *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 370 (1945).

4. Section 212 of the 1954 Code, authorizing the deduction of certain non-business expenses related to income, is restricted in its application to taxpayers classified as individuals and has no application to corporate taxpayers.

5. Section 212 is the successor (and, so far as is pertinent here, contains identical language) to § 23(a)(2) of the 1939 Code, as amended. Section 23(a)(2) came into being only with the enactment of § 121(a) of the Revenue Act of 1942. Prior thereto the statute had restricted the deduction for an ordinary and necessary expense to one paid or incurred in carrying on any trade or business. *Higgins* v. *Commissioner*, 312 U.S. 212 (1941); *City Bank Farmers Trust Co.* v. *Helvering*, 313 U.S. 121 (1941); *United States* v. *Pyne*, 313 U.S. 127 (1941). The Committee Reports accompanying the 1942 Act observed of the expanded statute that, except for the trade or business requirement, a deduction under the new § 23(a)(2) was sub-

ject to all limitations theretofore applicable with respect to an expense paid or incurred in carrying on any trade or business. H. R. No. 2333, 77th Cong., 2d Sess., p. 75, 1942-2 C. B. 372, 430; S. R. No. 1631, 77th Cong., 2d Sess., p. 88, 1942-2 C. B. 504, 571. The effect of the addition to the statute, therefore, was to eliminate the trade or business requirement for a deduction which otherwise might be available to an individual. That the addition "did not enlarge the range of allowable deductions of 'business' expenses" (footnote omitted) is apparent from *McDonald* v. *Commissioner*, 323 U.S. 57, 62 (1944) [opinion of Mr. Justice Frankfurter]; *Trust of Bingham* v. *Commissioner*, supra, pp. 373-74 of 325 U.S.; and *United States* v. *Gilmore*, 372 U.S. 39, 44-45 (1963). See *Whipple* v. *Commissioner*, 373 U.S. 193, 200 (1963). See, also, *Davis* v. *Commissioner*, 151 F.2d 441, 443 (8 Cir. 1945), cert. denied 327 U.S. 783, and *Spangler* v. *Commissioner*, 323 F.2d 913, 918 (9 Cir. 1963). Indeed, *Bingham* and *Gilmore* describe §§ 23(a)(1) and (2) [and, hence, §§ 162(a) and 212] as *in pari materia*. As a consequence, we cannot accept the argument, if one is made here, that the criteria for determining deductibility under § 162(a) are different from those for determining deductibility under § 212, except, of course, the trade or business aspect of § 162(a) and the income aspect of § 212.

6. Although the title cases regard litigation expenses in connection therewith as capital expenditures, there are other cases which allow legal fees and expenses as deductions. Examples are *Kornhauser* v. *United States*, 276 U.S. 145 (1928); *United States* v. *Pate*, 254 F.2d 480 (10 Cir. 1958); and *Ticket Office Equipment Co.*, 20 T. C. 272, 280 (1953), aff'd on another issue, 213 F.2d 318 (2 Cir.). One might suspect offhand that these two lines of authority in some degree are inconsistent. See *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373, 378 (Ct. Cls. 1960). The inconsistency, if it exists at all, may, however, not possess real depth or significance. Many of the opinions

recognize and refer to both lines of cases. Some of the non-title cases seek only monetary damages or concern only cash. We venture to repeat the Supreme Court's statement, noted above, that there is no "ready touchstone" for every conceivable and variable fact situation and to note that our comments in *Industrial Aggregate Co.* v. *United States*, supra, p. 645 of 284 F.2d., namely, that "Practicality and substance are to be recognized" and that "The test which appears to have been established is that of *primary purpose*", may have proper pertinency in most situations.

The Commissioner relies primarily upon two cases. The first is this court's decision in *Helvering* v. *Stormfeltz*, 142 F.2d 982 (8 Cir. 1944). There a minor, upon attaining his majority, sought recovery from his estate guardian of funds allegedly embezzled. He was successful. His attorneys received a contingent fee for their services. The ward asserted this fee and attendant legal expenses as deductions under § 23(a)(2) of the 1939 Code. This court held, p. 984, that, to the extent the recovery consisted of interest, it was income and the expense of its collection was deductible but that, to the extent the recovery was of capital, the collection expense was not deductible. "The expenses here are analogous to expenditures incurred for the purpose of protecting title to property. It has been held that under this amendment such expenses are not deductible because they are capital expenditures". The Iowa court in the *Bechtel* litigation characterized a corporation's officers and directors as "trustees or quasi trustees for the corporation and its stockholders" and observed that they "occupy a fiduciary relation to the Corporation". Pp. 215-16 and 225 of 51 N.W.2d. On this analysis *Stormfeltz* is precedent for the present case in the Commissioner's favor.

The Commissioner's second primary case is *Pennroad Corp.*, 21 T.C. 1087 (1954), affirmed, 228 F.2d 329 (3 Cir.). There shareholders' derivative suits were settled after ex-

tensive litigation for $15,000,000 in cash. Substantial legal fees and expenses were awarded from the amount so recovered. The Tax Court held, pp. 1098-99, that the settlement sum was a recovery of capital resulting in no taxable income and that fees and expenses paid to the corporation's separate counsel were not deductible under § 23 (a)(1)(A) of the 1939 Code because "It is well settled that expenses of acquiring, perfecting, or recovering title to property are non-deductible capital expenses". *Stormfeltz* was cited in support of this conclusion. The decision was one reviewed by the full court. The appeal to the Third Circuit did not concern the issue as to the deductibility of the fees and expenses.

The taxpayer's response to *Stormfeltz* is that it concerned § 23(a)(2), rather than § 23(a)(1); that it was decided before *Bingham* came down in 1945; and that *Stormfeltz* would have gone the other way had it postdated *Bingham*. Its response to *Pennroad* is that the decision is just plain wrong; that the issue there was a minor one, as compared with amounts otherwise involved, and was not appealed; and that it was based on *Stormfeltz* and on a Tax Court case later reversed by the Ninth Circuit.

The taxpayer, further, places reliance on the case of *California & Hawaiian Sugar Ref. Corp.* v. *United States*, 311 F.2d 235 (Ct. Cls. 1962). There it was held by a divided court that legal expenses incurred in recovering unconstitutionally imposed processing and floor stock taxes were deductible. The majority refused to accept the proposition that legal expenditures must always be non-deductible where "capital" is involved; drew a distinction between gaining a tax refund and recovering non-monetary property having a basis which can be adjusted; distinguished *Pennroad* because "it involved the question of what was the proper amount * * * to pay for the capital assets" and was a decision which was "simply one of many refusing deductions from ordinary income for ex-

penditures made to realize capital gains, or minimize possible capital losses"; cited *Stormfeltz;* and, while apparently not critical of our actual holding there, observed that if this court's general reference to "capital expenditures" was "intended as applicable to all returns of capital, it was dictum at best, and in our view far too broad". Footnote 12, pp. 243-44 of 311 F.2d.

We need not be much concerned here with the question whether *California & Hawaiian* is sound insofar as the court drew a distinction between recovery of taxes and one of non-cash properties, for the present taxpayer's recovery, although in money, related to non-cash assets possessing a basis. As to these the Court of Claims seemed to recognize the usual rules. Note the later unanimous opinion of the same court in *Manufacturers Hanover Trust Co.* v. *United States*, 312 F.2d 785 (1963), cert. denied 375 U.S. 880. See the Ninth Circuit's critical comments in *Spangler* v. *Commissioner*, supra, p. 920 of 323 F.2d, as to any claimed distinction in the cash recovery situation.

From the facts, from the observations we have made, and from the decided cases, certain factors emerge and impress us:

1. The state court action had to do with the excess of the purchase prices paid by the taxpayer for assets transferred to it. The purchase prices, incontrovertibly, are capital in character. The state litigation therefore concerned capital items.

2. What was desired in the state action was an adjustment in the prices. On this issue it was not, basically, a suit for damages. Although it sought a monetary return and resulted in cash being collected, this, realistically, could only operate as and be a reduction of the prices charged to the taxpayer. We start with capital and we conclude with an adjustment in that capital. Thus, the fees and expenses incurred related directly to capital.

3. The transferred assets were non-cash in character and were basis possessing properties.

4. The cash collections could logically be expected to have pertinency in the adjustment of basis.

5. The argument made by the taxpayer that, although the record does not disclose it, it has not had the interim benefit of oversized depreciation allowances and abandonment losses occasioned by the excess acquisition costs, seems to us to involve different issues and different taxable years which were not before the Tax Court and are not before us now.

6. This taxpayer was not itself an active participant in the recovery. Instead, although by its pleadings it alleged laches and the statute of limitations, pp. 180 and 218 of 51 N.W.2d., it adopted a neutral and largely non-participating posture.

7. The Tax Court's determination here is primarily factual in nature.

8. The Supreme Court tells us that "it is the origin of the liability" and "the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling". *Deputy* v. *duPont*, 308 U.S. 488, 494, 496 (1940); *United States* v. *Gilmore*, supra, pp. 47-48 of 372 U.S. Here that origin is capital.

These factors in the aggregate, it seems to us, clearly bring this case down on the side of non-deductibility. This conclusion appears to us to be consistent with established and accepted general rules and does no violence to those rules or, for that matter, to any concept of fairness in income taxation. We regard *Spangler* v. *Commissioner*, supra, and *Munson* v. *McGinnes*, 283 F.2d 333 (3 Cir. 1960), cert. denied 364 U.S. 880, as particularly significant authority. In the former the Ninth Circuit said, p. 920 of 323 F.2d.:

> "Since perfection of taxpayer's claim to ownership was the essence of the suit, the costs of the litigation were capital expenditures and, under the authorities cited, were not expenses deductible from ordinary income."

In the latter, the Third Circuit said, p. 336 of 283 F.2d.:

> "Each expense which must be capitalized presents the simple economic reality of a particular cost of a particular capital transaction."

We find no substance in the taxpayer's alternative argument that merely because an amount paid is in discharge of a judgment against it for fees and expenses, it is deductible as a business expense.

Affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

T. C. Memo. 1962-267

TAX COURT OF THE UNITED STATES

IOWA SOUTHERN UTILITIES COMPANY, a Corporation, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 84035. Filed November 16, 1962.

Held, allocation is approved of attorneys' fees and legal expenses of a derivative action taxed against petitioner based upon the recovery in such action of both income and capital. That portion of the fees and

expenses attributable to the recovery of capital is not deductible as an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code of 1954. *Pennroad Corporation*, 21 T.C. 1087, affd. 228 F. 2d 329, followed.

Charles T. Akre, Esq. and *Robert Valentine, Esq.*, for the petitioner.

Ivan L. Onnen, Esq., for the respondent.

Memorandum Opinion

MULRONEY, *Judge:* The respondent determined a deficiency in petitioner's 1955 income tax in the amount of $111,019.06.

All of the facts are stipulated and they are found accordingly.

The only issue presented is whether petitioner is entitled to a deduction of $160,218.66 representing attorney fees that it paid in 1955 to the attorneys who successfully prosecuted a derivative action on its behalf and for and on behalf of its stockholders.

Petitioner is a Delaware corporation, formed in 1923, and engaged in manufacturing and transmitting electrical energy with its principal place of business in Centerville, Appanoose County, Iowa. It filed its 1955 income tax return with the district director of internal revenue at Des Moines, Iowa.

On or about May 7, 1943, certain minority stockholders of petitioner, on behalf of themselves and other stockholders similarly situated and on behalf of petitioner, brought their derivative action in the District Court of Appanoose County, Iowa, against petitioner's majority stockholder, George M. Bechtel, and others, to recover losses sustained by the corporation by reason of the wrongful actions of its directors and others.

The petition, as amended, alleged that George M. Bechtel and Harold R. Bechtel, in conspiracy, cooperation and connivance with others of the defendants, fraudulently and wrongfully and in breach of their fiduciary relations to petitioner in the acquisition of property for petitioner, secretly obtained it at prices greatly less than the prices at which it was turned into the company, and that the Bechtels and J. Ross Lee and other named defendants wrongfully appropriated the excess consideration. The petition also alleged that the defendants, Edward L. Shutts, E. F. Bulmahn and others, without the authority or knowledge of the directors, wrongfully appropriated by means of a secret account in the Harris Trust & Savings Bank of Chicago many thousands of dollars of the company's funds.

After extended litigation, involving in all three appeals to the Supreme Court of Iowa, it was finally ordered by the Supreme Court of Iowa (*Des Moines Bank & Trust Co.* v. *George M. Bechtel & Co.*, 243 Iowa 1007, 51 N.W. 2d 174, Jan. 8, 1952) that judgment be entered in said derivative action in favor of petitioner and against George M. Bechtel, Harold R. Bechtel, and Estate of J. Ross Lee, because of their property acquisition manipulations, in the total sum of $2,211,549.68 with legal interest.[1] The Iowa Supreme Court also held that the secret salary paid to the defendant Edward L. Shutts, the then president of petitioner, was illegal and ordered judgment against him and in favor of petitioner in the sum of $46,728.29.

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[1] The parties stipulate: "It is agreed that for purposes of this proceeding, the facts found by the Supreme Court of Iowa in the above-captioned opinion are considered true and are incorporated herein by reference as part of this stipulation."

The petitioner has received to apply on the judgment against George M. Bechtel, Harold R. Bechtel and J. Ross Lee, a total of $487,655.03, as follows:

1953	$386,123.42
1954	101,531.61
Total	$487,655.03

The petitioner received from Edward L. Shutts the total sum of $67,219.30 as follows:

1953	$ 46,728.29
1954	20,491.01
Total	$ 67,219.30

Respondent included in petitioner's income for the year 1953 the sum of $39,339.98 being that portion of the recovery received by petitioner in that year for which it had received a tax benefit in previous years by reason of having claimed a deduction for salary paid Shutts, a portion of which salary was held to be illegal and which was the basis of the Shutts' judgment. Petitioner reported as interest income the $20,491.01 received by it in the year 1954. When reconciling the petitioner's general books to its tax records the balance of the monies received pursuant to the Des Moines Bank case was closed out to an asset account on the petitioner's general books entitled "Intangible Capital —Organization and Going Concern." With the exception of the amounts stated above relative to the Shutts' judgment no part of these judgments or recoveries has been reported as income by the petitioner.

On December 21, 1954, the attorneys who represented the stockholders who instituted the Des Moines Bank case and obtained the judgments, filed an application in the District Court in Appanoose County, Iowa, seeking an allowance of fees and expenses against the petitioner herein in connection with said litigation and collection on the judgments as above described, and on June 29, 1955, the Judge of said

Court, after a full hearing on said application, entered a judgment and decree in the amount of $160,077.66 and court costs in the amount of $141 as against the petitioner herein and in favor of said attorneys.

Petitioner paid the judgment for attorney fees and costs in the sum of $160,218.66 in 1955 and took deduction therefor from its gross income. Respondent, in his notice of deficiency, disallowed the deduction as not being "an ordinary or necessary business expense."

Petitioner contends the legal expenses for the derivative suit are deductible under the provisions of section 162(a), Internal Revenue Code of 1954, which provides:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, • • •

It is a general rule of law, which both parties recognize here that the plaintiff in a successful stockholders' suit is entitled to recover from the corporation his necessary legal expenses out of funds recovered for the corporation or on the basis of savings or benefits received. Fletcher Cyclopedia Corporations, Sec. 6045; *Ontjes* v. *Mac Nider*, 234 Iowa 208, 12 N.W. 2d 284; *Charles Kay Bishop*, 25 T.C. 969; *Shoe Corporation of America*, 29 T.C. 297; and *B. T. Harris Corporation*, 30 T.C. 635.

Petitioner supports its contention by an argument that the expenditure was both ordinary and necessary and therefore it is deductible under the cited statute. But the statute also requires that the expenditure be for an item of "expense". Money spent by a corporation in acquiring or recovering capital is not an ordinary "expense of the operation of a business". *Welch* v. *Helvering*, 290 U.S. 111; *Pennroad Corporation*, 21 T.C. 1087, aff'd. 228 F. 2d

329. The status of attorney's fees as to deductibility from income is to be determined by the recovery sought and obtained.

The general rule is that if the legal expenses are incurred to recover income they are deductible and if they are incurred to recover capital in the form of property or money, they are not. *Pennroad Corporation, supra; Helvering* v. *Stormfeltz*, 142 F. 2d 982.

The recovery obtained in the derivative action here in the form of a money judgment could not be anything other than recovery of income or capital. Respondent argues all but the interest was a recovery of capital. Petitioner treated all but the interest as a recovery of capital for it did not report it as income. Petitioner makes no argument here that the recovery, other than the interest, was not capital. Petitioner disputes the existence of any general rule that legal expenses for the recovery of capital are not deductible. We think the rule is well settled by the authorities cited and cases cited in those opinions.

This case is ruled by our opinion in *Pennroad Corporation, supra.* There we held the $15,000,000 recovered in the settlement of two derivative actions "constituted a recovery of capital resulting in no income taxable to the petitioner." On the next issue as to the deductibility of the attorneys' fees under section 23(a)(1)(A), Internal Revenue Code of 1939 (now section 162(a), Internal Revenue Code of 1954) we said:

> Having found in the case at bar that the settlement represented recovery of capital, we think it clear that the fees and expenses paid in connection with that settlement were of a capital nature and may not be deducted as ordinary and necessary business expenses.

Petitioner's only argument with respect to *Pennroad Corporation* is that it was wrongly decided, chiefly because it relied on cases involving deductibility of legal expenses

by individuals under section 23(a)(2), Internal Revenue Code of 1939 (now section 212, Internal Revenue Code of 1954). When section 23(a)(2) was added to the business expense statute (section 121 of the Revenue Act of 1942) it did not enlarge the class of expenses deductible under section 23(a). It merely enlarged the category of incomes from which the expenses could be deducted. Under either statute, now section 162 and section 212 of the Internal Revenue Code of 1954, the money paid must be for an *expense* as distinguished from a capital expenditure before any question of such payment being ordinary or necessary is reached. *Bingham's Trust* v. *Commissioner*, 325 U.S. 365; *James C. Coughlin*, 3 T.C. 420.[2]

Consistent with our holding in *Pennroad*, we hold that the legal expenses for recovery of what both parties treated as capital are not deductible. Respondent's determination of deficiency disallowed the entire legal expense. On brief respondent now states:

> On its 1954 return, petitioner reported as interest income the $20,491.01 received by it on the Shutts judgment. Furthermore, the petitioner paid tax on $39,339.98 in 1953 which was that portion of the recovery received by it in that year for which it had received a tax benefit in previous years by reason of having claimed a deduction for salary paid Shutts. Thus, of the total recoveries of $554,874.33 petitioner has actually paid a tax on a total of $59,830.99, or approximately 10.7828 per cent. To be consistent with our theory that that part of the legal expense is deducible which is attributable to income and that part which is attributable to capital is nondeductible, it appears that a portion of the legal expense, approximating 10.7828 per cent, or $17,276.06, is deductible and the remainder is not. * * *

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[2] See also Deductibility of Legal and Accounting Fees by Ewing Everett, 6 N.Y.U. Tax Inst., pp. 616, 617.

Petitioner argues strenuously for the deduction of the entire amount of legal expenses but does not comment on the allocation now conceded by respondent. We hold $17,276.06 of the legal expenses are deductible and the remainder not deductible.

Petitioner makes some alternative arguments which we have examined and which we find are without merit. One is that the fees and expenses were incurred in defense of an accounting action. It is true legal fees paid in defense of an accounting action against a corporation are generally deductible. It is not clear that accounting was sought *against* the corporation here but at any rate plaintiffs were unsuccessful for no accounting relief was granted.

Petitioner argues the legal expenses were paid in discharge of a judgment against the corporation. That does not automatically make the payment deductible as an ordinary and necessary expense of carrying on the business. The judgments in this case for attorney fees were entered in the very case the attorneys prosecuted, namely the *Des Moines Bank & Trust Co.* case, upon the application of the attorneys who were awarded the judgments. The payment of such judgments in favor of the attorneys would be no different in character from a voluntary payment of attorney fees. A final argument is made that presents the theory that the legal expenditure was made to recover lost or stolen property. The record just does not support a conclusion that the object of the derivative action was to recover the corporation's property that had been lost or stolen.

Judgment for respondent that gives effect to the previously mentioned allocation will be entered under Rule 50.

Decision will be entered under Rule 50.

Judgment

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 17,377

September Term, 1963

Thursday, June 25, 1964

IOWA SOUTHERN UTILITIES COMPANY, a Corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for Review of the Decision of the Tax Court of the United States.

This cause came on to be heard on the Petition to review the Decision of The Tax Court of the United States entered on January 3, 1963, determining that there is a deficiency in the income tax of the petitioner for the taxable year 1955, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the Decision of The Tax Court of the United States in this cause be, and the same is hereby, affirmed.

And it is further Ordered by this Court that the Petition to review in this cause be, and the same is hereby, dismissed.

June 25, 1964.